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UNCLAS SECTION 01 OF 03 PRAGUE 000204

SIPDIS

STATE FOR EUR/NCE, EB/CBA AND EB/IFD/OIA
COMMERCE FOR 4232/ITA/MAC/MROGERS
TREASURY FOR OIA

E.O. 12958: N/A
TAGS: EINV ECON EZ
SUBJECT: FIRMS WITH FOREIGN INVESTMENT ADD MORE VALUE, HAVE CHANGED FACE OF CZECH INDUSTRY. HOW TO KEEP THEM COMING?

¶1. Summary: Much of the Czech Republic's economic growth over the past several years has been attributable to significant flows of foreign direct investment (FDI) that have made the country the destination for more such investment per capita in recent years than any other country of central and eastern Europe. FDI has transformed the Czech economy with new capital, technology and management methods. Foreign investors pay above-average wages that have boosted real incomes over the past five years and advanced the convergence of the Czech economy with that of its EU partners. Besides contributing directly to GDP, FDI has helped to increase the quality of Czech exports to the extent that they have easily held up under the pressure of a rising exchange rate. On the other hand, some resentment among Czechs has surfaced recently over foreign investor's supposedly "excessive" repatriation of earnings and their use of government investment incentives. The USG will have to formulate a position on continuation of investment incentives if the opposition ODS, which opposes them, takes power in ¶2006. The ODS has no plans to disturb incentives already granted. The challenge for the Czech Republic in the near future will be to continue to attract high levels of foreign investment, or to find new factors that can contribute as strongly to growth. End Summary.

¶2. The Czech Republic has been remarkably successful in attracting foreign investment, based on its relatively lower labor costs compared to Western Europe, its well-educated workforce, its central location in Europe, and the incentives it offers to investors. Using OECD figures on investment from 1994 to 2003, the stock of foreign investment in the Czech Republic per capita was $3715, compared to $3176 in Hungary, $2037 in Slovakia and $1347 in Poland. 2003 was a relatively slow year in the Czech Republic for FDI, but the Czechs still edged out the Hungarians for the per capita honors among the Visegrad countries, according to the OECD. Investor interest revived in 2004 and the Czech Republic should again be drawing significantly more per capita on an annual basis than its neighbors, if the trends of the first two quarters of 2004 continue.

¶3. A recent study by the Czech Statistical Office indicates that firms under foreign control with more than 100 employees are one-third more productive than similarly-sized Czech firms. Firms under foreign control are 26% of registered companies with more than 100 employees. However, among such large companies, they produce 43% of added value, 47% of total revenues, 52% of gross profits, and 70% of exports. The major sectors into which foreign investment flowed over the 1990's are banking and finance, telecommunications, packaged food and drink, automobiles and auto parts, and tobacco. Interestingly, some Czech subsidiaries are doing better financially than their foreign parent firms. This is true of some of the banks. Another example is Skoda Auto, which is not burdened by over-employment and strikes that hamper its parent Volkswagen. Skoda is becoming a foreign investor itself, with assembly plants in Ukraine, Bosnia and India.

¶4. Foreign investment has transformed the face of Czech industry over the past ten years. The list of the twenty largest Czech firms in 1994 was almost exclusively composed of firms in the iron, steel, energy and chemical sectors, along with the telephone and tobacco monopolies. The 2003 list contains some of the same names, such as CEZ, the state-owned electrical utility, but now features Foxconn, a computer and electronics producer based in Taiwan, retailers such as Holland's Makro and Ahold, auto parts maker Bosch, and mobile phone operators Eurotel and T-Mobile. Other foreign names on the 2003 list are Siemens and Ispat, the Anglo-Indian firm that owns the steelworks at Nova Hut. Steel and chemicals have not disappeared from the list and are still key Czech products for both domestic use and export.

¶5. The government recognizes that the Czech Republic cannot continue forever as a low-wage manufacturing economy, and is trying to sharpen the focus of its investment incentive scheme to attract research and development and business support services. Forty percent of the investment going

through the investment promotion agency CzechInvest is now flowing into such businesses. Companies such as Exxon-Mobil, DHL, IBM, Honeywell, Accenture and others have located R&D or services centers in the Czech Republic over the past few years.

¶6. The 600 million euro Toyota-Peugeot-Citroen joint venture in Kolin is scheduled to begin producing its first cars for sale in February 2005. However, CzechInvest rates the likelihood of another such gigantic single investment in the future as low. Ford Motors recently decided to locate a plant in Slovakia -- the Czech Republic's closest competitor for major investment. Legislators in the Czech Republic are warily eyeing Slovakia's flat 19% tax and more advanced pension and health care reforms. CSSD legislators are doubtful that a flat tax could produce the needed level of revenue in the Czech Republic, and the chances of major tax, pension and health care reforms are dwindling away as the 2006 elections approach.

¶7. The ODS made a flat tax a feature of its election campaign in 2002 and will do so again in 2006. They promise a host of reforms that will benefit the climate for doing business in the Czech Republic, if they can force them through parliament after taking power. However, the ODS is conceptually opposed to incentives as an economic distortion of investment decisionmaking, a drain on government finances, and unfair to domestic companies who cannot invest above the threshold amounts for receiving incentives. The generally free-market ODS politicians are not hostile to foreign investment per se, but they feel no urge to give it special advantages over domestic companies. The likely advent of an ODS government in 2006 would present the USG with a dilemma over whether to support the continuation of investment incentives. In a recent meeting, the governor of the Moravian-Silesian region, Evzen Tosenovsky, assured us the ODS would never touch incentives already granted. He also foresees that doing away with incentives will not be accomplished as easily as some in the ODS suggest, because of the wide range of laws that would have to be amended.

¶8. Investments of $10 million can qualify for incentives that include relief from corporate taxes for ten years, job creation grants, retraining grants and opportunities to obtain low-cost land. The current system of incentives was developed with input from the European Union and was not affected by the Czech Republic's entry into the EU. It is relatively transparent, with clear rules about who is and is not entitled to incentives. If it were abolished, it is quite possible that the government would not be able to resist offering ad hoc incentives if presented with a large new investment proposal that would go to a neighboring country if the GOCR were unwilling to step up to the plate. Too-frequent resort to such ad hoc incentives would be less desirable than the system in place.

¶9. Doing business in the Czech Republic is still an exercise in red tape that probably affects domestic small and medium businesses even more than well-heeled foreign investors who have the support of the investment promotion agency CzechInvest. The judicial system still operates glacially. More and more often, the European Court of Justice is imposing stiff penalties on the GOCR, recompensing citizens whose cases have languished for so long the Court deems their rights to have been violated. Corruption is an ongoing problem, with 21% of Czechs sampled by the 2004 Transparency International Global Corruption Barometer poll admitting to having given a bribe in the past year. Corruption can be particularly off-putting to American firms that face tougher standards than many of their foreign competitors. The American Chamber of Commerce and the Embassy have stressed repeatedly to Czech politicians the importance of such basic reforms as simplifying the process of registering companies and modernizing the unwieldy bankruptcy laws -- changes which would also have a healthy impact on corruption. The parliament recently amended the company registration law favorably. It will likely soon amend the bankruptcy law to strengthen the rights of banks that lend to small businesses. However, a much-needed comprehensive overhaul of the bankruptcy code is tied up in discussions within the government.

¶10. According to the Ministry of Finance, the final count of inward flows of foreign direct investment is expected to reach a satisfactory $4-4.5 billion in 2004, compared to $2.5 billion in 2003. The Czech Republic still retains its natural advantages: a skilled workforce, average wages only a quarter of those in the EU, a central location in Europe, a well-developed communications and transport infrastructure. The country is a pleasant place for managers to live, a factor that should not be discounted in investment decisions. However, Czech politicians cannot ignore the competition for the investor's dollar or euro. They must pay attention to fundamentals of the tax, legal and ethical environment that are just as important to investor's decision-making.